

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF GENERAL RATES OF)	CASE NO.
DELTA NATURAL GAS COMPANY, INC.)	97-066

O R D E R

Delta Natural Gas Company ("Delta") and the Attorney General ("AG") have petitioned for rehearing on the Commission's Order of December 8, 1997. After reviewing these petitions and the responses thereto, the Commission finds that rehearing should be granted on the issues of Accumulated Deferred Incomes Taxes ("ADIT") and adjusted income taxes. By this Order, the Commission also corrects certain clerical errors contained in its Order of December 8, 1997.

DELTA'S MOTION FOR REHEARING

Accumulated Deferred Income Taxes. In its motion for rehearing, Delta contends that the Commission erred in accepting the AG's proposed methodology for calculating ADIT includable in Delta's rate base. In its application, Delta requested that the Commission include the net of all ADIT items or, in the alternative, the ADIT associated with alternative minimum taxes ("AMT") in the rate base calculation. The AG argued that rate base should be determined by examining individual ADIT accounts and including only those amounts directly related to rate base. The AG pointed to several ADIT accounts which were unrelated to rate base components and advocated their exclusion from rate base.

Delta advances two arguments in favor of rehearing. First, it contends that the AG's proposed methodology is contrary to past Commission precedent. The Commission, however, has recently used an account-by-account determination to establish rate base.¹ Moreover, Delta fails to provide any authority for the proposition that its proposal is based upon Commission precedent. It makes no reference to any specific Commission Order. Delta's most recent rate cases were resolved by settlement agreements. In its Orders approving those agreements, the Commission did not expressly discuss ADIT for rate-making purposes. In its final Order in Delta's last fully adjudicated rate case,² the Commission did not discuss AMT. Moreover, the record of that case does not indicate that Delta had any active subsidiaries.

As to its second argument, Delta contends that the Commission improperly used the account-by-account method to determine Delta's rate base. Reviewing this argument and noting the new evidence which Delta has presented in its motion, the Commission finds that rehearing should be granted on this issue to permit Delta to present evidence on how much of its ADIT associated with AMT is related to its regulated enterprise.

Capitalization. In its motion for rehearing, Delta contends that the Commission erred in the manner in which it removed \$935,406 of investment in non-regulated subsidiaries from Delta's capital structure. In its Order of December 8, 1997, the Commission removed all of Delta's investment from the equity capital component of Delta's capital structure because Delta recorded 100 percent of this investment in accordance with the equity

¹ See Case No. 97-034, Kentucky-American Water Co. (Sept. 30, 1997).

² Case No. 9331, Delta Natural Gas Co. (Nov. 15, 1995).

method. Delta contends that the Commission should have adjusted Delta's capital structure by the removal, on a ratable basis, of its investment in its non-regulated subsidiaries.

Based upon its review of the motion and the evidence of record, the Commission denies the motion for rehearing on this issue. The Commission's action is based upon sound regulatory principles. Delta's proposal would result in the overstatement of equity capital by the difference between the ratable amount removed from equity capital and the amount actually recorded in that account related to non-regulated subsidiaries. Moreover, Delta has presented no new evidence or argument on this issue. It contends the Commission's action is inconsistent with prior Commission precedent, but has failed to refer to any Commission proceeding in which the Commission expressly addressed the issue.

Revenue Normalization. In its motion for rehearing, Delta seeks review of the use of an adjustment to reflect growth in the residential and commercial customer classes. Delta characterizes this adjustment as a "forecasted exercise" which is inconsistent with the use of an historic test period.

The Commission does not accept Delta's characterization of this adjustment. The adjustment is an appropriate means of achieving a match between the various rate-making components (i.e., revenues, expenses, capital and rate base) when utilities use test year-end rate base and capital and update test year expenses to reflect more current operating conditions. Addressing the same argument in its Order of December 8, 1997, the Commission stated that the adjustment was not a post-test year adjustment

"because the AG's calculation of residential and commercial customer levels does not use levels beyond the end of the historic test period."³

The Commission is not persuaded by Delta's argument that the AG failed to demonstrate a direct relationship between utility plant growth and customer growth. The important relationship, from a rate-making perspective, is the matching of the various rate-making components within the context of an historic test year. Without a customer growth adjustment, test year average revenues will not match the other components as well as with such an adjustment. Adjustments to normalize revenues for the purpose of reflecting customer growth during the test year have been made in other rate proceedings before this Commission. Accordingly, the Commission finds that the motion on rehearing on this issue should be denied.

Wages and Salaries. In its Order of December 8, 1997, the Commission disallowed the inclusion of \$24,000 in compensation to Delta's president Glenn Jennings. This compensation was in the form of forgiveness of repayment of the principal on a mortgage that Delta holds on Mr. Jennings' home. In its motion for rehearing, Delta contends that the level of Mr. Jennings' compensation is reasonable given his position and level of competency. In support of its motion, Delta refers to a study of executive compensation that it commissioned from Stone and Webster Management Consultants and which purports to show that Mr. Jennings' compensation is less than the average base salary of chief executive officers of ten roughly comparable utilities.

³ Order of December 8, 1997 at 10.

After reviewing the record and considering Delta's motion, the Commission denies rehearing on this issue. The Commission disallowed the amount in question not because of the form of the compensation, but because it deemed that amount to be excessive in light of Delta's size. Moreover, the Commission did not find the results of the Stone and Webster study to be persuasive. The study involved only one company which was comparable to Delta in terms of total revenue - the only benchmark used to gauge the reasonableness of compensation levels. The average gross revenues of the ten companies included in the salary comparison were \$66 million or nearly 60 percent larger than Delta's annual revenues.

The study suggests that Mr. Jennings' compensation level exceeded that of comparable utility executives. At the time of the compensation study, Delta's unadjusted revenues were approximately \$38 million. Edison Sault (Electric) with annual revenues of \$37 million was the utility most similar to Delta. Its chief operating officer and president received an annual base salary of \$116,000. In contrast, Mr. Jennings received a base salary of \$143,000.

Return on Common Equity. In its Order of December 8, 1997, the Commission found a range of 11.1 to 12.1 percent⁴ to be the reasonable return on equity for Delta and selected the midpoint as the specific return granted. Stating that risk associated with an investment in its common stock is higher than similarly situated companies, Delta contends that its overall rate of return should have been calculated using the highest end of the

⁴ As a result of a typographical error in the Order of December 8, 1997, the range was incorrectly stated as "11.11 to 12. 1" percent. Order of December 8, 1997 at 20. In this Order, the Commission corrects this error.

range - 12.1 percent. As the range established in the December 8, 1997 Order recognizes Delta's own risk level and was not intended to be representative of any group of proxy companies, the Commission denies Delta's motion for rehearing on this issue.

Implementation. In its motion for reconsideration, Delta requests that the rates established as a result of any Order on rehearing be made effective for final meter reads on and after the date of such Order. Delta contends that such action is necessary to improve its financial condition and ensure its financial liability. While recognizing Delta's concerns, the Commission finds that the requested relief would require the Commission to engage in retroactive rate-making. As KRS Chapter 278 does not authorize the Commission to retroactively establish rates in an Order on rehearing, the Commission is limited to establishing rates prospectively. Therefore, the Commission denies Delta's requested relief concerning the implementation on any new rate.

AG'S REQUEST FOR RECONSIDERATION

References to AG Witnesses. In his request for reconsideration, the AG states that the Commission in its discussion on the appropriate rate of return in the Order of December 8, 1997 incorrectly identified the AG witness who presented testimony of that issue. After reviewing the record, the Commission finds that it erroneously attributed the testimony of AG Witness Carl Weaver to AG Witness David Brown Kinloch and that the Order of December 8, 1997 should be amended to correct this error.

Adjusted Income Taxes. In the Order of December 8, 1997, the Commission found that Delta's adjusted income tax expense for the test period was \$1,015,659.⁵ His

⁵ Order of December 8, 1997 at 17 - 18.

attempts to replicate the Commission's calculations having failed to produce the same expense level, the AG has requested that the Commission review its calculations. Based upon this review, the Commission has discovered a data entry error. When making its calculations, the Commission inadvertently entered excess deferred taxes as \$2,650 instead of \$26,150. The correct level of adjusted income tax expense is \$992,159⁶ and requires a reduction of approximately \$39,000 in Delta's revenue requirements. Accordingly, the Commission grants rehearing on this issue and, upon final resolution of all issues, will order new rates reflecting this reduction in Delta's revenue requirements.

Customer Deposits. The AG has requested that the Commission reconsider its treatment of customer deposits. In its Order of December 8, 1997, the Commission excluded customer deposits from Delta's capital structure, but included interest on such deposits in Delta's operating expenses. The AG argues that such treatment deprives

⁶	Operating Revenues	\$39,008,112
	Less: Operating Expenses w/o income tax	
-	Purchased Gas Expense	(21,550,508)
-	O&M Expense	(7,818,021)
-	Depreciation Expense	(2,684,844)
-	Other Taxes	(1,004,570)
	Less: Pro Forma Interest Expenses	<u>(3,188,580)</u>
	Taxable Income	2,761,589
	Combined State and Federal Tax Rate	<u>39.445%</u>
	Income Taxes	1,089,309
	ITC Amortization	(71,000)
	Amortization of Excess Deferred Tax	<u>(26,150)</u>
	Adjusted Net Income Taxes	<u><u>\$992,159</u></u>

Delta's customers of their statutory right to interest on customer deposits by requiring those customers to pay that interest in the form of higher gas rates.

The Commission is unpersuaded by the AG's arguments. As KRS 278.460 requires the payment of such interest and as Commission regulations authorize a utility to require a deposit as a means of protecting the utility and its customer from delinquent customers, interest on such deposits is a cost of providing utility service and should be recovered as a reasonable operating expense. Accordingly, the Commission denies the AG's petition for rehearing on this issue.

IT IS THEREFORE ORDERED that:

1. Delta's Motion for Rehearing with respect to the issue of ADIT is granted.
2. Delta's Motion for Rehearing with respect to all other issues is denied.
3. All references on pages 19 and 20 of the Commission's Order of December 8, 1997 to "AG Witness David Brown Kinloch" are amended to "AG Witness Carl Weaver."
4. The AG's Request for Reconsideration with respect to the issue of Adjusted Income Taxes is granted.
5. The AG's Request for Reconsideration with respect to the treatment of Customer Deposits is denied.
6. The third paragraph, first sentence of page 20 of the Commission's Order of December 8, 1997 is amended to read as follows: "Having considered all of the evidence, including economic conditions, the Commission finds that an ROE of 11.1 to 12.1 percent is fair, just, and reasonable."

7. A formal hearing on the issue of ADIT shall be held on April 2, 1998, at 9:00 a.m., Eastern Standard Time, in Hearing Room 1 of the Commission's offices at 730 Schenkel Lane, Frankfort, Kentucky, and continuing until completed.

8. On or before February 2, 1998, Delta shall serve upon the AG and file with the Commission in verified form the direct testimony of each witness whom it expects to call at the formal hearing. Delta shall further file with such testimony all workpapers that address how much of ADIT associated with AMT is related to Delta's regulated enterprise.

9. On or before February 12, 1998, the AG may serve upon Delta and file with the Commission any requests for information.

10. On or before February 23, 1998, Delta shall serve upon the AG and file with the Commission its responses to all requests for information.

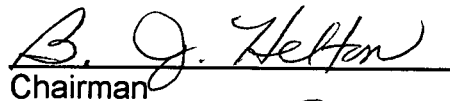
11. On or before March 5, 1998, the AG shall serve upon Delta and file with the Commission in verified form the direct testimony of all witnesses whom he intends to call at the formal hearing.

12. On or before March 16, 1998, Delta may serve upon the AG and file with the Commission any requests for information.

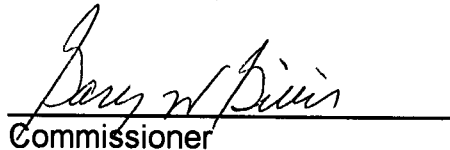
13. On or before March 26, 1998, the AG shall serve upon Delta and file with the Commission his responses to all requests for information.

Done at Frankfort, Kentucky, this 20th day of January, 1998.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director